



Signed: February 08, 2006

Leslie Tchaikovsky

LESLIE TCHAIKOVSKY
U.S. Bankruptcy Judge

UNITED STATES BANKRUPTCY COURT
NORTHERN DISTRICT OF CALIFORNIA

In re
QMECT, INC., etc.,
Debtor-in-Possession.

No. 04-41044 T
Chapter 11

In re
FRED AND LINDA KOELLING,
Debtors-in-Possession.

No. 04-46443 T
Chapter 11

QMECT, INC., etc.,
Plaintiff,

A.P. No. 04-4190 AT
A.P. No. 04-4365 AT
A.P. No. 04-4366 AT

vs.

(Consolidated)

BURLINGAME CAPITAL PARTNERS II,
L.P., etc. et al.,

Defendants.

AND RELATED ADVERSARY PROCEEDINGS

1 **DECISION AFTER TRIAL IN CONSOLIDATED PROCEEDINGS**

2 The above-captioned adversary proceedings were tried to the
3 Court on October 24, 25, 26, 27 and 28, and December 7, 2005 and
4 on January 9, 10, 11, and 12, 2006. Closing argument was
5 presented on January 24, 2006. The Court's findings of fact and
6 conclusions of law are set forth below.

7 **GENERAL FINDINGS OF FACTS¹**

8 1. Qmect, Inc. ("Qmect"), a California corporation, is
9 engaged in the electroplating business in Northern California.
10 Fred and Linda Koelling (the "Koellings") are the principal
11 shareholders of Qmect. Fred Koelling is Qmect's president; Linda
12 Koelling is its secretary; and the Koellings are Qmect's
13 directors.

14 2. Qmect operates its business primarily at a facility in
15 Union City, California (the "Qmect Real Property"), which it built
16 in the late 1990s. The business was previously operated through
17 a general partnership known as Koelling-McNeill (the
18 "Partnership"), of which Fred Koelling was a general partner. The
19 Partnership operated its business at a rented facility in Hayward,
20 California.

21 3. In 1995, the Partnership decided to build its own
22 facility. For that purpose, it purchased the Qmect Real Property
23

24
25 _____
26 ¹Findings of fact should be construed as conclusions of
law, and conclusions of law should be construed as findings of
fact where appropriate. See Fed. R. Bankr. Proc. 7052.

1 and in 1996 began construction. At some point in the process,
2 Qmect was formed, and the Partnership sold its assets to Qmect.

3 4. In 1997, Qmect obtained loans from Comerica Bank-
4 California ("Comerica") to assist in the construction of the new
5 facility for a total of \$1.8 million (the "Original Comerica
6 Loans"). The Original Comerica Loans were comprised of four
7 separate loan facilities: (a) two loans secured by a first
8 priority deed of trust on the Real Property (the "Comerica Deed of
9 Trust"), (b) a line of credit secured by Qmect's accounts
10 receivable, and (c) a loan secured by Qmect's equipment.

11 5. The Koellings executed personal guaranties of Qmect's
12 obligations to Comerica (the "Comerica Guaranties"). The Comerica
13 Guaranties were secured by the Koellings' personal real and
14 personal property assets.

15 6. Qmect was unable to complete construction of the facility
16 for the amount of the Original Comerica Loans. Consequently, in
17 1998, Qmect obtained an additional loan from Comerica in the face
18 amount of \$2,100,000 (the "Flat Note Loan"). The facility was
19 completed in January 2000. Shortly thereafter, Comerica began
20 urging the Koellings to find a source of funds to pay off the Flat
21 Note Loan.

22 7. In December 1999, Qmect retained Sierra Financial Group
23 ("Sierra") to provide consulting services for this purpose.
24 Robert and Janice Judson (the "Judsons") were the principals of
25 Sierra.
26

1 8. In or about December 2000, the Judsons formed Burlingame
2 Capital Partners II, L.P. ("Burlingame") as a fund to make
3 "mezzanine" loans. In the Spring of 2001, Burlingame offered to
4 loan Qmect \$2,000,000 to enable Qmect to pay off the Flat Note
5 Loan (the "Burlingame Loan").

6 9. The Burlingame Loan did not close until November 2001
7 (although \$100,000 of the loan was funded in September 2001).
8 During the Summer of 2001, the Koellings caused \$1,500,000 to be
9 advanced to Qmect to enable it to meet its operating expenses (the
10 "\$1.5 Million Loan").

11 10. The \$1.5 Million Loan was secured by real property (the
12 "Kids Connection Real Property") owned by Kids Connection, Inc.
13 ("Kids Connection"), a corporation owned by Linda Koelling. The
14 funds were wired directly from Kids Connection's bank account to
15 Qmect's bank account. However, on advice of the Koellings'
16 accountant, the \$1.5 Million Loan was documented as a loan by Kids
17 Connection to the Koellings followed by a loan by the Koellings to
18 Qmect. In connection with the Burlingame Loan, the Koellings
19 signed an agreement, providing that repayment of the \$1.5 Million
20 Loan would be subordinated to the Burlingame Loan (the "Burlingame
21 Subordination Agreement").

22 11. In November 2001, shortly before the Burlingame Loan was
23 due to close, Burlingame insisted that the Koellings execute a
24 personal guaranty of the Burlingame Loan (the "Burlingame
25 Guaranty"). The Burlingame Guaranty included the following
26 provision (the "Carve Out"):

1 9. Notwithstanding anything to the contrary
2 contained in the instrument, no recourse may
3 be had against, no judgment satisfied out of,
4 any of the Excluded Assets (as defined below)
5 for or arising out of any obligations,
6 liabilities or indemnities of Guarantor. As
7 used herein, the term "Excluded Assets" shall
8 mean and refer to any and all of Guarantor's
9 ownership in Kids Connection, Inc.
10 Notwithstanding the foregoing, any asset which
11 would otherwise be included in the definition
12 of Excluded Assets, shall not be considered a
13 part of Excluded Assets if Guarantor invests
14 additional cash or other assets in Kids
15 Connection, Inc. or Guarantor purchases
16 additional shares of stock or any other form
17 of ownership in Kids Connection, Inc. without
18 Lender's prior written consent.

11 12. The Burlingame Guaranty was secured by Fred Koelling's
12 stock in Qmect (the "Qmect Stock Collateral"). At that time, the
13 Qmect Stock Collateral represented a controlling interest in
14 Qmect.

15 13. The Burlingame Loan was used in part to pay off the Flat
16 Note Loan. The net proceeds of the Burlingame Loan, after paying
17 off the Flat Note Loan, were largely used to pay interest to
18 Burlingame and a \$60,000 finder's fee to Sierra.

19 14. Qmect was unable to service the Burlingame Loan, and it
20 went into default in July 2002.

21 15. In October 2002, Qmect and the Koellings filed an action
22 in state court against the Judsons, Sierra, and Burlingame for
23 fraud and negligent misrepresentation, among other things (the
24 "Breach of Fiduciary Duty Action"). However, the complaint in
25 that action (the "Breach of Fiduciary Duty Complaint") was not
26 served on the defendants at that time.

1 16. In September 2002, Linda Koelling entered into an
2 agreement with Kids Connection, increasing her annual salary from
3 \$80,000 to \$225,000 and securing the obligation by a deed of trust
4 on the Kids Connection Real Property (the "September 2002 Salary
5 Increase").

6 17. During the fall of 2002, Qmect engaged Alternative
7 Capital Strategies, LLC ("ACS") to assist it in reorganizing its
8 financial affairs.

9 18. In November 2002, Robert Judson wrote a letter to the
10 investors in Burlingame, expressing his concern that Qmect or a
11 party friendly to Qmect might purchase the Original Comerica Loans
12 (the "November 2002 Investor Letter"). He stated that such a
13 purchase could be detrimental to Burlingame. He did not express
14 the view that such a purchase would violate any agreement between
15 Burlingame and either Comerica or Qmect.

16 19. In the November 2002 Investor Letter, Robert Judson also
17 stated that Burlingame had been in negotiations with Comerica with
18 regard to Burlingame's purchase of the Original Comerica Loans at
19 a discount of approximately \$100,000 of their face amount.
20 Burlingame did not inform Qmect or the Koellings about its
21 negotiations with Comerica.

22 20. In the November 2002 Investor Letter, Robert Judson also
23 stated that he did not wish to foreclose on the Qmect Stock
24 Collateral because Qmect had a number of unpaid liabilities,
25 including unpaid payroll taxes.
26

1 21. In early 2003, ACS located a proposed lender, Structured
2 Capital Group ("SCG"). The principal of SCG is an individual
3 named Basem Zakariya ("Zakariya"). SCG made a proposal to
4 Comerica and Burlingame for a restructuring of Qmect's secured
5 debt. Neither secured creditor was interested in the proposal.

6 22. On May 28, 2003, SCG sent a letter to Comerica, offering
7 to purchase the Original Comerica Loans. The letter offered two
8 alternative prices: (1) \$2.7 million, of which \$1.8 million would
9 be paid to Comerica at closing, the remaining \$900,000 of which
10 would be placed in an escrow or with a court pending resolution of
11 a dispute between Comerica and Qmect concerning this portion of
12 the debt or (2) \$2.1 million at closing in full satisfaction of
13 the purchase price and in settlement of all claims.

14 23. In or before May 2003, the Breach of Fiduciary Duty
15 Complaint was served on the Defendants. On May 29, 2003,
16 Burlingame e-mailed to the Koellings a notice of the proposed
17 foreclosure sale of the Qmect Stock Collateral which was scheduled
18 to take place on June 12, 2003.

19 24. On or before June 4, 2003, Burlingame learned that SCG
20 was attempting to purchase the Original Comerica Loans. On June
21 4, 2003, Burlingame's counsel sent a letter to Comerica's counsel,
22 threatening to sue Comerica if Qmect or a Qmect affiliate
23 purchased the Original Comerica Loans (the "First Litigation
24 Threat Letter").

25 25. In the First Litigation Threat Letter, Burlingame's
26 counsel claimed that Comerica's sale of the Original Comerica

1 Loans to a third party without giving Burlingame 90 days' prior
2 notice would violate Burlingame's subordination agreement with
3 Comerica (the "Comerica Subordination Agreement"). Burlingame's
4 counsel also asserted that the sale of the Original Comerica Loans
5 to an affiliate of Qmect would violate various provisions of the
6 Burlingame Loan agreement (the "Burlingame Loan Agreement").
7 Qmect was not provided with a copy of the First Litigation Threat
8 Letter.

9 26. On June 9, 2003, Comerica sent a letter to Qmect and
10 Burlingame, by fax and personal delivery, informing them that
11 Comerica had decided to sell the Original Comerica Loans. The
12 letter disclosed that Comerica had received an offer to purchase
13 the Original Comerica Loans from an entity that appeared to be
14 affiliated with Qmect. The letter stated that the offer had now
15 expired. In the letter, Comerica proposed to give the parties an
16 opportunity to bid against each other for the purchase of the
17 Original Comerica Loans.

18 27. On June 9, 2003, Qmect issued additional shares and
19 transferred them to Robert McNeill ("McNeill"), Business Debt
20 Solutions ("BDS"), and Qmect Funding, LLC ("Qmect Funding").² The
21 result of this transaction was that the Qmect Stock Collateral no
22 longer represented a controlling interest in Qmect. On the same
23 day, Qmect's Board of Directors adopted a corporate resolution
24

25 ²McNeill was an existing shareholder. BDS was an entity
26 which had previously provided consulting services to Qmect.
Qmect Funding was an entity formed by Zakariya in anticipation
of acquiring the Original Comerica Loans.

1 purporting to make Zakariya a director. On the same day, the
2 Koellings assigned to Kids Connection their right to repayment by
3 Qmect of the \$1.5 Million Loan.

4 28. On June 10, 2003, Qmect sought a temporary restraining
5 order in state court of the proposed stock foreclosure sale.
6 Qmect did not disclose to the state court or to Burlingame at that
7 time that it had issued additional stock in Qmect. The temporary
8 restraining order was denied.

9 29. On June 12, 2003, the day of the foreclosure sale, Fred
10 Koelling informed Robert Judson about the issuance and transfer of
11 the additional stock. As a result, Burlingame chose not to
12 proceed with the foreclosure sale. Instead, the parties discussed
13 a strategy for cooperative bidding for the Original Comerica
14 Loans.

15 30. On or about June 14, 2003, Burlingame, Qmect, the
16 Koellings, and SCG entered into a written agreement concerning
17 bidding for the Original Comerica Loans (the "June 14 Agreement").
18 The June 14 Agreement contained the following provisions:

19 (A) Before 9:00 a.m on June 16, 2003, Qmect and the Koellings
20 would dismiss with prejudice the third and fourth claim in the
21 Breach of Fiduciary Duty Complaint: i.e., the fraud and negligent
22 misrepresentation claims.

23 (B) Before 3:00 p.m. on June 17, 2003, Burlingame would make
24 an offer to purchase the Original Comerica Loans at a price
25 determined to be appropriate by Burlingame. Burlingame agreed to
26 provide a copy of the offer to SCG at the time the offer was

1 submitted to Comerica. If the offer were rejected or a
2 counterproposal were made by Comerica, Burlingame and SCG would
3 cooperate in determining the appropriate response.

4 (C) If Comerica did not accept Burlingame's offer (or any
5 subsequent offer submitted by Burlingame) by September 15, 2003,
6 then Burlingame and SCG would each be entitled to submit
7 independent offers to purchase the Original Comerica Loans. Until
8 then, neither Qmect nor SCG, nor any of their affiliates would
9 submit an offer to purchase the Original Comerica Loans.

10 (D) If Comerica accepted Burlingame's offer to purchase the
11 Original Comerica Loans by September 15, 2003, then SCG would have
12 90 days from the date of purchase to purchase a 50 percent
13 interest in the Original Comerica Loans. The purchase price for
14 this 50 percent interest would be 50 percent of the price paid by
15 Burlingame plus 50 percent of the interest accruing on the
16 Original Comerica Loans from the date of purchase to the date of
17 payment for the 50 percent interest. Alternatively, SCG had the
18 right, instead of purchasing the 50% interest in the Original
19 Comerica Loans, to payment of \$250,000. These rights would not
20 apply if Burlingame purchased the Original Comerica Loans after
21 September 15, 2003.

22 (E) If Burlingame or any party affiliated with Burlingame
23 purchased the Original Comerica Loans, Burlingame would release
24 the Koellings from the Comerica Guaranties. This provision was
25 subject to the following handwritten provision, referred to as
26 Rider 1 (the "Good Faith Provision"):

1 All parties agree to cooperate in good faith
2 to achieve the purposes of this agreement. No
3 party shall be deprived of any benefit of this
4 agreement under this provision unless and
5 until a court has ruled that such party has
6 acted in bad faith and should be deprived of
7 such benefit.

8 Without limiting the foregoing, with respect
9 to the unconditional guaranty, in the event
10 that Burlingame should make a claim that
11 Koelling acted in bad faith with regard to the
12 joint bidding process, the guaranty shall
13 remain in effect, and Burlingame shall take no
14 action to enforce it, until a court has ruled
15 on the matter. If Burlingame & Company [i.e.,
16 SCG] have both bid on the notes and Burlingame
17 has purchased the bank documents and the court
18 has ruled that Koelling acted in bad faith in
19 the joint bidding process, then the court may
20 order that Koelling guaranty will not [be]
21 released.

22 (F) Finally, the June 14 Agreement provided that nothing in
23 the agreement would affect the rights, remedies or obligations of
24 Burlingame, Qmect or the Koellings under the Burlingame Loan
25 Agreement.

26 31. Burlingame made an offer to purchase the Comerica Loans
for \$1,600,000 on or before June 17, 2003. Comerica rejected the
offer without making a counteroffer. Shortly thereafter, Ken
Tamizato ("Tamizato"), the loan officer from Comerica in charge of
the Original Comerica Loans, called Fred Koelling and inquired why
Burlingame was the only party bidding. Fred Koelling did not
disclose the existence of the June 14 Agreement to Tamizato.
Tamizato told Fred that he would have to "turn the heat up": e.g.,
by calling the loans so that the loans would accrue interest at a

1 default rate. Fred Koelling conveyed the substance of this
2 conversation to Robert Judson.

3 32. On June 20, 2003, counsel for Burlingame wrote another
4 letter to counsel for Comerica (the "Second Litigation Threat
5 Letter"). In the Second Litigation Threat Letter, counsel
6 asserted again that sale of the Original Comerica Loans to Qmect
7 or a Qmect affiliate would violate the Comerica Subordination
8 Agreement as well as the Burlingame Loan Agreement. He also
9 asserted that, by threatening to begin charging default interest
10 on the Original Comerica Loans under these circumstances, Comerica
11 would be exposing itself to a lawsuit by Qmect. Qmect was not
12 provided with a copy of the Second Litigation Threat Letter.

13 33. After Comerica rejected Burlingame's initial offer to
14 purchase the Original Comerica Loans, on or about July 15, 2003,
15 Burlingame and Qmect entered into a term sheet (the "July 15 Term
16 Sheet"). The July 15 Term sheet provided for two alternative
17 courses of action, designated as Plan A and B.

18 (A) Plan A provided that, subject to Comerica's approval,
19 Qmect and the Koellings would execute a deed in lieu of
20 foreclosure to Burlingame, transferring Qmect's assets to
21 Burlingame, in partial satisfaction of its debt. The amount of
22 the debt would be agreed upon between the parties. The assets
23 would be transferred into a new company, into which Burlingame
24 would inject \$500,000 of equity. Qmect's debt to Comerica would
25 become the debt of the new company.
26

1 (B) Plan B provided that, if Comerica did not approve of Plan
2 A, the capitalization of Qmect would be restored so that the
3 shares held by Burlingame to secure the Burlingame Guaranty would
4 represent 95 percent of all outstanding stock. Burlingame would
5 be entitled to replace any individuals on the Board of Directors
6 who were no longer shareholders. It was anticipated that the new
7 Board might elect to file a chapter 11 petition on behalf of the
8 new company. Under this scenario, Burlingame would have no
9 obligation to make any loans or capital contributions to Qmect.

10 (C) Under either Plan A or B, Fred Koelling would continue to
11 serve as President of Qmect, but not as CEO, for one year, at a
12 specified salary, an agreement which could be renewed annually.
13 His duties would be primarily in sales and research and
14 development. He would continue to be a member of the Board of
15 Directors. Burlingame agreed not to enforce the Burlingame
16 Guaranty during this one year period and to release the Koellings
17 from the Burlingame Guaranty at the end of the year provided Fred
18 Koelling complied with his obligations under the employment
19 agreement.

20 34. On September 5, 2003, Burlingame made a second offer to
21 purchase the Original Comerica Loans. This time, the offer was
22 for only \$1,400,000, \$200,000 less than the original offer. SCG
23 was given notice of Burlingame's intention to make this offer
24 shortly before it was communicated to Comerica and did not object
25 to the amount. Comerica rejected the offer and did not make a
26 counteroffer.

1 35. The 90 day period during which, pursuant to the June 14
2 Agreement, Burlingame had the exclusive right to bid on the
3 Original Comerica Loans until September 15, 2003. Neither Qmect
4 nor SCG, nor any of their affiliates, made any attempt to bid on
5 the Original Comerica Loans during that period.

6 36. Comerica would not agree to Plan A set forth in the July
7 15 Term Sheet. Fred Koelling asked Robert Judson why they could
8 not then proceed in accordance with Plan B. On September 16,
9 2003, Robert Judson wrote a letter to Fred Koelling, expressing
10 various reasons why Plan B did not appear viable.

11 37. On October 13, 2003, Qmect Funding, the entity formed by
12 Zakariya in anticipation of purchasing the Original Comerica
13 Loans, wrote a letter to Tamizato, offering to purchase the
14 Original Comerica Loans for \$1.7 million. Comerica agreed to sell
15 the Original Comerica Loans to Qmect Funding for this amount (the
16 "Qmect Funding Sale Agreement") and loan documents were drafted.
17 Neither SCG nor the Koellings advised the Judsons of the Qmect
18 Funding Sale Agreement.

19 38. On October 29, 2003, Robert Judson wrote to Fred
20 Koelling, requesting updated financial information, ostensibly to
21 assist Burlingame in continuing its attempt to purchase the
22 Original Comerica Loans. Fred Koelling did not provide the
23 requested information until January 14, 2004.

24 39. In early January 2004, the Judsons learned about the
25 impending sale of the Original Comerica Loans to Qmect Funding.
26 On January 14, 2004, Robert Judson e-mailed Fred Koelling, asking

1 him to confirm or deny whether this transaction was in progress.
2 In the e-mail, he asserted that the purchase of the Original
3 Comerica Loans by Qmect Funding would violate the Burlingame Loan
4 Agreement.

5 40. On January 14, 2004, Burlingame's counsel wrote to
6 counsel for Comerica, making the same assertions made in the e-
7 mail to Fred Koelling and threatening legal action (the "Third
8 Litigation Threat Letter"). On January 22, 2004, Burlingame
9 issued deposition subpoenas directed to Tamizato and Comerica in
10 the Breach of Fiduciary Duty Action.

11 41. On January 16, 2004, Burlingame's counsel wrote to
12 counsel for Zakariya, asserting that his efforts to purchase of
13 the Original Comerica Loans violated the Burlingame Loan
14 Agreement.

15 42. Notwithstanding these threats, negotiations between
16 Comerica and Qmect Funding concerning the purchase of the Original
17 Comerica Loans proceeded. However, Comerica insisted that
18 Zakariya personally agree to indemnify Comerica from any suit by
19 Burlingame regarding the transaction. Zakariya refused to do so.
20 On January 23, 2004, Zakariya signed the draft Qmect Funding Sale
21 Agreement and sent it to Comerica, with the indemnification
22 provision deleted. He also sent Comerica a \$25,000 deposit.

23 43. On January 26, 2004, counsel for Burlingame wrote to
24 counsel for Comerica, offering to purchase the Original Comerica
25 Loans for \$50,000 more than the \$1.7 million offered by SCG.
26 Comerica asked Burlingame to indemnify it from any suit by Qmect

1 or Qmect Funding. Burlingame refused. Nevertheless, on or about
2 February 2, 2004, Burlingame and Comerica executed an agreement
3 providing for the sale of the Original Comerica Loans to
4 Burlingame for \$1,825,000 (the "Burlingame Loan Sale Agreement").
5 The Burlingame Loan Sale Agreement did not include an
6 indemnification agreement.

7 44. Shortly after acquiring the Comerica Loans, Burlingame
8 commenced foreclosure proceedings with respect to Qmect's personal
9 property assets and filed suit against the Koellings in state
10 court on the Burlingame Guaranty (the "Guaranty Action").

11 45. On February 27, 2004, Qmect filed a chapter 11 petition
12 to stop the foreclosure sale.

13 46. Shortly thereafter, Burlingame transferred the Original
14 Comerica Loans to a newly formed entity ("Burlingame Funding").

15 47. On November 16, 2004, the Koellings filed a chapter 11
16 petition.

17 48. Burlingame and Burlingame Funding filed timely proofs of
18 claim (the "Proofs of Claim") in both chapter 11 cases.

19 49. After the chapter 11 cases were filed, the two lawsuits
20 between the parties filed in state court were removed to the
21 bankruptcy court. The Guaranty action was designated A.P. No. 04-
22 4365 AT (the "Guaranty Action") and the Breach of Fiduciary Duty
23 Action was designated A.P. 04-4366 AT. Some of the claims in
24 those actions were subsequently remanded to state court.
25
26

1 50. During the chapter 11 case, Qmect commenced A.P. No 04-
2 4190 AT (the "Equitable Subordination Action"). The three
3 adversary proceedings were consolidated for trial.

4 51. On or about August 24, 2005, the Court granted summary
5 judgment with respect to some of the claims asserted in the
6 consolidated adversary proceedings. Shortly before the trial
7 commenced, the Court permitted Burlingame and Qmect to amend their
8 pleadings to dismiss certain claims, to add other claims, and to
9 add new parties to existing claims.

10 **CONCLUSIONS OF LAW (INCLUDING CLAIM SPECIFIC FINDINGS OF FACT)**

11 As noted above, this decision addresses claims asserted in
12 three adversary proceedings which were tried to the Court on a
13 consolidated basis. The Court's findings and conclusions with
14 respect to the claims asserted in the Equitable Subordination
15 Action, A.P. No. 04-4190 AT, are set forth in Section A below.
16 The Court's findings and conclusion with respect to the claims
17 asserted in the Guaranty Action, A.P. No. 04-4365 AT, are set
18 forth in Section B below. The Court's findings of fact and the
19 conclusions of law with respect to the Breach of Fiduciary Duty
20 Action, A.P. No. 04-4366 AT, are set forth in Section C below.

21 **A. EQUITABLE SUBORDINATION ACTION**

22 As tried to the Court, the Equitable Subordination Complaint
23 included four claims for relief: (1) Intentional Interference With
24 Prospective Economic Advantage, (2) Breach of Contract, (3) Breach
25 of Covenant of Good Faith and Fair Dealing, and (4) Objection to
26 Claims. The first three claims were asserted only as offsets to

1 the Proofs of Claim and not as a basis for affirmative relief.
2 The Court's findings of fact and its conclusions of law with
3 respect to these claims for relief are set forth in sections A-1,
4 A-2, A-3, and A-4, respectively. Qmect has the burden of proof
5 with respect to the first three claims. The burden of proof with
6 respect the fourth claim for relief will be discussed in section
7 A-4.

8 **1. Intentional Interference With Prospective Economic**
9 **Advantage**

10 In this claim for relief, Qmect alleged that Burlingame
11 intentionally interfered with its prospective economic advantage
12 by sending the Litigation Threat Letters. It alleged that this
13 was intended to and did disrupt Qmect Funding's attempt to
14 purchase the Original Comerica Loans to its detriment.³ The
15 elements of a claim for intentional interference with prospective
16 economic advantage are: (1) an economic relationship between the
17 plaintiff and a third party containing the probability of future
18 benefit to the plaintiff; (2) knowledge by the defendant of the
19 existence of the relationship; (3) intentional acts on the part of
20 the defendant designed to disrupt the relationship; (4) actual
21 disruption of the relationship; and (5) damages to the plaintiff
22 proximately caused by the acts of the defendant. Della Penna v.
23 Toyota Motor Sales, U.S.A., Inc., 11 Cal. 4th 376, 389, 393 (1995).
24

25 ³This claim is also asserted against Burlingame Funding.
26 However, no evidence was presented supporting such a claim in
that Burlingame Funding was not formed until after the conduct
in question occurred.

1 The acts that caused the disruption must be wrongful as a legal
2 matter for some reason other than that they interfered with the
3 prospective economic relationship. Id., at 393.

4 At trial, Qmect presented persuasive evidence that it had an
5 economic relationship with Qmect Funding and that Burlingame knew
6 of this economic relationship. It also presented persuasive
7 evidence that Burlingame sent the Second and Third Litigation
8 Threat Letters with the intention of disrupting that prospective
9 economic relationship. As discussed in the next claim for relief,
10 the Court was also persuaded that these acts actually disrupted
11 that relationship. Furthermore, the Court was persuaded that
12 these acts were otherwise wrongful in that they constituted a
13 breach of the June 14 Agreement.

14 However, as discussed more fully in connection with the next
15 claim for relief, for breach of contract, the Court finds and
16 concludes that this claim must fail for two reasons. First, Qmect
17 failed to persuade the Court that there was a probability of
18 future benefit to Qmect if Qmect Funding acquired the Original
19 Comerica Loans. Second, for the same reason, Qmect failed to
20 persuade the Court that it was damaged by Burlingame's disruption
21 of the prospective economic relationship. Given this conclusion,
22 the Court need not address the defenses to this claim raised by
23 Burlingame: e.g., that the claim is barred by the competition
24 privilege or the litigation privilege.

25 **2. Breach of Contract**

26

1 In this claim for relief, Qmect alleged that Burlingame
2 breached the June 14 Agreement by causing Comerica to renege on
3 the Qmect Funding Loan Sale Agreement. It alleged that Comerica's
4 failure to sell the Comerica Loans to be Qmect Funding caused
5 Qmect to suffer damages in an amount to proven at trial. Qmect
6 alleged that it performed all of its obligations under the June 14
7 Agreement.

8 Based on the evidence presented at trial, the Court finds and
9 concludes that Qmect performed all of its obligations under the
10 June 14 Agreement. The Court finds and concludes that Burlingame
11 breached the Good Faith Provision of the June 14 Agreement by
12 sending the Second and Third Litigation Threat Letters to
13 Comerica.

14 In the June 14 Agreement, Burlingame agreed that, if it failed
15 to purchase the Original Comerica Loans by September 15, 2003,
16 Burlingame and SCG would each be entitled to make independent bids
17 for the Original Comerica Loans. The Good Faith Provision
18 provided that Burlingame, SCG, and Qmect would all cooperate in
19 good faith to achieve the purposes of the June 14 Agreement.
20 Burlingame breached the Good Faith Provision by interfering with
21 SCG's rights to make an independent bid for the Original Comerica
22 Loans after the 90 days had expired.⁴

23
24
25
26 ⁴The Court does not consider significant the fact that
Zakariya intended to purchase the Original Comerica Loans
through Qmect Funding rather than SCG.

1 Burlingame contended that the June 14 Agreement did not give
2 SCG the right to bid for the Original Comerica Loans even after
3 the expiration of the 90 day period. It contended that the
4 purchase of the Original Comerica Loans by Qmect Funding violated
5 its rights under the Burlingame Loan Agreement, among other
6 things, and that it preserved its right to object to SCG bidding
7 in paragraph 5 of the June 14 Agreement.⁵ Jan Judson testified
8 that this understanding of the June 14 Agreement was discussed
9 among the parties at the time the agreement was executed of the
10 June 14 Agreement. The Court did not believe Jan Judson's
11 testimony. The plain language in paragraph 2 states otherwise.
12 Had the parties agreed to such an important provision, the Court
13 believes that it would have been spelled out more clearly in the
14 June 14 Agreement.

15 The Court also finds and concludes that the Second and Third
16 Litigation Threat Letters caused Comerica to renege on the Qmect
17 Funding Loan Sale Agreement. The Court was persuaded that
18 Zakariya could have obtained the financing required to purchase
19 the Original Comerica Loans and would have completed the purchase
20 had Comerica not insisted on being indemnified. The Court was
21 also persuaded that Comerica would have sold the Original Comerica
22 Loans to Qmect Funding without requiring the indemnification but
23 for the Second and Third Litigation Threat Letters. The critical
24

25 ⁵As noted above, paragraph 5 of the June 14 Agreement
26 provided that nothing in the agreement would affect the rights,
remedies or obligations of Burlingame, Qmect or the Koellings
under the Burlingame Loan Agreement.

1 evidence supporting this conclusion is the fact that Comerica sold
2 the Original Comerica Loans to Burlingame even though Burlingame
3 refused to indemnify Comerica.

4 The Court was not persuaded that Comerica sold the Original
5 Comerica Loans to Burlingame because Burlingame offered more
6 money. Had price been the issue, Comerica would have gone back to
7 Qmect Funding for a higher bid. Although Burlingame's offer to
8 close the transaction in seven days may have been attractive to
9 Comerica, particularly at the time the offer was made, the Court
10 is persuaded that the sale to Qmect Funding could have closed
11 sooner than the sale to Burlingame had Burlingame not interfered
12 with the sale to Qmect Funding.

13 However, to prevail on its breach of contract claim, Qmect
14 must establish that it was damaged by Burlingame's breach. Thus,
15 Qmect was required to persuade the Court that, more probably than
16 not, it would have been better off if Qmect Funding had purchased
17 the Original Comerica Loans than it is now as a result of
18 Burlingame having purchased them. For this purpose, Qmect called
19 Zakariya as a witness.

20 Zakariya testified that, if Qmect Funding had acquired the
21 Original Comerica Loans, he intended to propose to Burlingame that
22 Qmect Funding reduce the amount of its secured claim to the amount
23 it had paid for the Original Comerica Loans. In return,
24 Burlingame would be required to convert \$1 million of its secured
25 claim to equity. Qmect Funding would also receive equity for the
26 amount it reduced its secured claim. Qmect's secured debt would

1 thereby reduced by almost \$2 million. The problem with this
2 proposal was that, to become a reality, it would have required
3 Burlingame's consent. Jan Judson testified that Burlingame never
4 would have agreed to such a proposal. The Court believed her.

5 The result of this proposal would have been that Fred
6 Koelling, Qmect Funding, and Burlingame would have shared the
7 equity in Qmect. It was not clear whether Qmect Funding would
8 have acquired a controlling interest by virtue of the transaction.
9 However, it might have since, according to Zakariya, it already
10 held a 35 percent equity interest. However, clearly, Burlingame
11 would have been a minority shareholder. The Court was persuaded
12 that Burlingame would not have been willing to accept such a role
13 in Qmect under the circumstances.

14 Qmect Funding could have pressured Burlingame to agree by
15 threatening to foreclose on Qmect's assets. Since the Original
16 Comerica Loans were senior to Burlingame's secured claim,
17 Burlingame's security interest would have been extinguished as a
18 result of such a foreclosure. However, Burlingame could have
19 purchased the Original Comerica Loans at the foreclosure sale,
20 albeit at the face amount. The Court is persuaded that Burlingame
21 would have preferred doing so to accepting the role of a minority
22 shareholder in a Qmect owned jointly with the Koellings and
23 Zakariya.

24 Qmect presented no other evidence concerning what would have
25 happened absent an agreement between Qmect Funding and Burlingame.

26 Qmect had no agreement with Zakariya that Qmect Funding would

1 convert any portion of the face amount of the Original Comerica
2 Loans to equity. Qmect Funding's acquisition of the Original
3 Comerica Loans would not have prevented Burlingame from
4 foreclosing. Thus, Qmect still would have been required to file
5 a bankruptcy petition to stay such a foreclosure. Given the
6 absence of persuasive evidence of damages, the Court is compelled
7 to find in favor of Burlingame on this claim.⁶

8 **3. Breach of Covenant of Good Faith and Fair Dealing**

9 In this claim for relief, Qmect alleged that Burlingame
10 breached the implied covenant of good faith and fair dealing with
11 respect to the June 14 Agreement by interfering with Qmect
12 Funding's attempt to purchase the Original Comerica Loans. This
13 claim duplicates the claim for breach of contract discussed in the
14 preceding section. For the same reason, failure to prove damages,
15 the Court finds in favor of Burlingame.

16 **4. Objections to Proofs of Claim**

17 In this claim, Qmect objected to proofs of claim filed by
18 Burlingame and Burlingame Funding, asserting claims in partially
19 quantified amounts.⁷ A properly executed and filed proof of claim
20

21 ⁶Burlingame asserts various defenses to this claim. Given
22 the Court's conclusion that Qmect has failed to prove that it
23 incurred any quantifiable damages as a result of Burlingame's
24 breach of the June 14 Agreement, the Court not need address
25 them.

26 ⁷They also filed proofs of claim asserting unquantified
amounts for damages, fees, and costs, and related items based on
the claims asserted in the Guaranty Action and the Burlingame
Cross-Complaint. Qmect did not object to these proofs of claim.
Thus, to the extent that Burlingame and Burlingame Funding have

1 is prima facie evidence of the validity and amount of the claim.
2 Fed. R. Bankr. Proc. 3001(f). Thus, unless an objection is filed
3 that is of sufficient substance to put the validity and/or amount
4 of the claim in controversy, the claim is deemed allowed. If a
5 sufficient objection is filed, the claimant has the burden of
6 proving its claim. The Court's findings and conclusions with
7 respect to these contested proofs of claim are set forth below.

8 **a. Burlingame's Proof of Claim**

9 Burlingame filed a proof of claim in the Qmect bankruptcy
10 case, asserting a secured claim in the principal amount of
11 \$2,000,000, for pre-petition interest of \$1,047,836.25, and for an
12 unquantified amount of late fees and costs of collection,
13 including attorneys' fees. Qmect objected to Burlingame's proof
14 of claim only on the ground that it was entitled to assert offsets
15 to those claims. Qmect had the burden of proof with respect to
16 these offset claims. As discussed elsewhere, the Court finds and
17 concludes that it failed to meet that burden.

18 At trial, Burlingame presented persuasive evidence
19 establishing certain elements of its claim that were not
20 quantified in its proof of claim--e.g., late charges and
21 attorneys' fees--and corrected certain mistakes in the quantified
22 portions of the proof of claim--e.g., pre-petition interest.
23 Based on the evidence presented, the Court finds and concludes
24

25 _____
26 established at trial the right to payment by Qmect based on the
claims asserted in the Guaranty Action and the Burlingame Cross-
Complaint, these claims are deemed allowed.

1 that Burlingame is entitled to an allowed claim in the Qmect
2 bankruptcy case in the following amounts: (a) \$2,000,000 in
3 principal, (b) \$1,043,635.01 in pre-petition interest, (c)
4 \$27,779.23 in late fees, and (d) \$357,998.59 in costs of
5 collection.⁸

6 **b. Burlingame Funding's Proof of Claim**

7 Burlingame Funding filed a proof of claim in the Qmect case,
8 asserting a claim in the principal amount of \$2,520,054.18, for
9 pre-petition interest totaling \$32,194.82, plus an unquantified
10 amount of late fees and costs of collection, including attorneys'
11 fees. Qmect objected to Burlingame's proof of claim on the ground
12 that the proof of claim was insufficiently detailed to establish
13 a prima facie case in support of the claim. Specifically, it
14 contended that the proof of claim was insufficient because it
15 failed to allocate the amounts owed among the four loan
16 facilities. The Court summarily adjudicated this issue in favor
17 of Qmect prior to trial.

18 _____
19 ⁸The Koellings are liable for Qmect's debts to Burlingame
20 pursuant to the Burlingame Guaranty. Burlingame filed a timely
21 proof of claim in the Koellings' bankruptcy case. The Koellings
22 did not object to the proof of claim. Nevertheless, at trial,
23 Burlingame presented sufficient evidence at trial to establish
24 certain unquantified portions of the claim that were different
25 from the claim asserted against Qmect: i.e., for pre-petition
26 interest, late fees, and collection costs accruing after Qmect
filed its bankruptcy petition and before the Koellings filed
their bankruptcy petition. Based on the evidence presented, the
Court finds and concludes that Burlingame's claim against the
Koellings should be allowed in the following amounts: (a)
\$2,000,000 in principal, (b) \$1,455,180.55 in pre-petition
interest, (c) \$40,057.01 in late fees, and (d) \$1,413,132.80 in
costs of collection.

1 At trial, Burlingame Funding presented persuasive evidence
2 establishing the amounts of its claim. Based on the evidence
3 presented, the Court finds and concludes that Burlingame Funding
4 is entitled to a allowed claim in the Qmect bankruptcy case in the
5 following amounts: (a) a claim for \$187,500 in principal and
6 \$1,696.31 in pre-petition interest pursuant to the variable rate
7 installment note, (b) a claim for \$537,816.96 in principal and
8 \$5,052.51 in pre-petition interest pursuant to the note secured by
9 a deed of trust, (c) a claim for \$894,737.22 in principal and
10 \$8,948.32 in pre-petition interest pursuant to the amended and
11 restated note secured by a deed of trust, and (d) a claim for
12 \$900,000 in principal and \$7,850.60 in pre-petition interest
13 pursuant to the master revolving note.⁹

14 **B. GUARANTY ACTION**

15 As tried to the Court, the Guaranty Action consisted of a
16 complaint filed by Burlingame against the Koellings (the "Guaranty
17 Complaint") and a cross-complaint filed by the Koellings against
18 Burlingame (the "Koelling Cross-Complaint"). The Court's findings
19

20
21 ⁹Burlingame Funding also filed a proof of claim in the
22 Koellings' bankruptcy case based on the Koellings' liability
23 under the Comerica Guaranties. Although the Koellings did not
24 file an objection to this proof of claim, Burlingame Funding
25 presented evidence in support of its claim against the Koellings
26 at trial. The only difference from the evidence presented in
support of Burlingame Funding's proof of claim in the Qmect case
was the accrual of additional pre-petition interest. However,
as discussed elsewhere, the Court has concluded that the
Koellings are entitled to a release of their liability pursuant
to the Comerica Guaranties. Therefore, this claim will be
disallowed.

1 and conclusions with respect to the claims asserted in the
2 Guaranty Complaint are set forth in section B-1 below. The
3 Court's findings and conclusions with respect to the claims
4 asserted in the Koelling Cross-Complaint are set forth in section
5 B-2 below.

6 **1. Guaranty Complaint**

7 As tried to the Court, the Guaranty Complaint included two
8 claims for relief: (a) breach of the Comerica Guaranties and (b)
9 declaratory relief. Burlingame Funding has the burden of proof on
10 both claims. The Court's findings of fact and conclusions of law
11 with respect to these claims are set forth in section B-1-a and B-
12 1-b, respectively.

13 **a. Breach of Comerica Guaranties**

14 In the first claim for relief, Burlingame Funding alleged as
15 follows:

16 In 1998, when Qmect obtained loans from Comerica to build its
17 new facility, the Koellings executed the Comerica Guaranties. On
18 February 5, 2004, Burlingame purchased the Original Comerica
19 Loans, including the Comerica Guaranties. On February 29, 2004,
20 Burlingame assigned the Original Comerica Loans, including the
21 Comerica Guaranties, to Burlingame Funding.

22 Commencing in 2003, Qmect defaulted on the Original Comerica
23 Loans. On various dates in 2003, Comerica sent notices of default
24 to the Koellings, demanding repayment of the amounts due under the
25 Original Comerica Loans. The Koellings have failed to comply with
26 their obligations pursuant to the Comerica Guaranties. Thus,

1 Burlingame Funding prays for judgment in the amount due under the
2 Comerica Guaranties.

3 At trial, Burlingame Funding presented persuasive evidence of
4 the allegations recited above and established the amounts due from
5 the Koellings pursuant to the Comerica Guaranties. However, as
6 discussed in connection with the next claim for relief, the Court
7 finds and concludes that the Koellings are entitled to a release
8 of their liability pursuant to the Comerica Guaranties by virtue
9 of the June 14 Agreement. Thus, judgment will be granted in favor
10 of the Koellings on this claim.

11 **b. Declaratory Relief**

12 In the second claim for relief, Burlingame alleged as follows:

13 On or about November 21, 2001, Burlingame and Qmect signed an
14 agreement (the "Burlingame Loan Agreement") pursuant to which
15 Burlingame loaned Qmect \$2,000,000 (the "Burlingame Debt").¹⁰
16 Thereafter, a dispute arose among the parties concerning the
17 Burlingame Loan Agreement. It alleged that, on or about October
18 23, 2002, Qmect and the Koellings filed suit against Burlingame
19 and others in San Mateo Superior Court, and that Burlingame filed
20 a cross-complaint against the Koellings.

21 On or about June 14, 2003, Burlingame, Qmect, the Koellings,
22 and SCG entered into the June 14 Agreement. The June 14 Agreement
23 gave Burlingame the exclusive right to bid on the Original
24 Comerica Loans from the date of the agreement to September 15,
25

26 ¹⁰The claim actually alleged that Qmect loaned this amount
to Burlingame. However, this is an obvious mistake.

1 2003. Thereafter, the June 14 Agreement provided, among other
2 things, that, if Burlingame had not purchased the Original
3 Comerica Loans by September 15, 2003, then Burlingame and SCG
4 would each be entitled to submit independent bids.

5 The June 14 Agreement provided that, if Burlingame were
6 successful in purchasing the Original Comerica Loans, the
7 Koellings would be released from the Comerica Guaranties.
8 However, the release was subject to a provision requiring all of
9 the parties to the June 14 Agreement to "cooperate in good faith
10 to achieve the purposes of" the agreement. If it were determined
11 that the Koellings acted in bad faith in the joint bidding
12 process, they would not be entitled to a release from the Comerica
13 Guaranties. The second claim for relief alleged that, although
14 Burlingame had acquired the Original Comerica Loans, the Koellings
15 were not entitled to a release from the Comerica Guaranties
16 because they acted in bad faith. Ten acts of bad faith were
17 alleged.

18 The second claim for relief alleged further that the June 14
19 Agreement gave Burlingame the right, if it acquired the Original
20 Comerica Loans, to appoint a new CEO to replace Fred Koelling.
21 This CEO would be entitled to remain in charge of Qmect as long as
22 any debt remained due from Qmect to Burlingame. Burlingame did
23 acquire the Original Comerica Loans and advised Fred Koelling that
24 it wished to appoint an individual named Robert Sick as CEO in
25 place of Fred. Fred Koelling refused to step down as CEO so as to
26 permit Robert Sick to take charge of Qmect.

1 In the second claim for relief, Burlingame sought a
2 declaration that the Koellings had acted in bad faith within the
3 meaning of the Good Faith Provision of the June 14 Agreement and
4 thus were not entitled to a release of the their liability under
5 the Comerica Guaranties. It also sought a declaration that, by
6 refusing to let Robert Sick take over as CEO of Qmect, the
7 Koellings "repudiated" the June 14 Agreement and thus were not
8 entitled to assert a right to a release of liability on the
9 Comerica Guaranties pursuant to that agreement.

10 There was no evidentiary dispute concerning the allegation
11 that Burlingame, Qmect, the Koellings, and SCG entered into the
12 June 14 Agreement. However, the parties disagreed about the
13 meaning of certain provisions of the June 14 Agreement. In
14 addition, conflicting evidence was presented concerning whether
15 the Koellings committed some of the acts or omissions complained
16 about by Burlingame Funding. There were also legal disputes
17 concerning whether these acts or omissions qualified as bad faith
18 within the terms of the June 14 Agreement. Finally, there were
19 factual and legal disputes regarding whether the Koellings
20 breached the June 14 Agreement by refusing to permit Robert Sick
21 to take over as CEO of Qmect and, if so, whether this deprived
22 them of the right to a release of liability pursuant to the
23 Comerica Guaranties. The Court's findings and conclusions with
24 respect to those disputes are as follows.

25 **(1) Construction of June 14 Agreement**
26

1 The parties read the June 14 Agreement differently in several
2 ways. First, the Koellings contended that the good faith
3 requirement only pertained to the initial 90 day period, during
4 which Burlingame had the exclusive right to attempt to purchase
5 the Original Comerica Loans. Burlingame contended that the
6 requirement continued throughout the bidding process. The Court
7 agrees with Burlingame's reading of the June 14 Agreement on this
8 point. The relevant language cannot reasonably be read as
9 limiting the effect of the Good Faith Provision to the initial 90
10 day period.

11 Second, the Koellings contended that, by agreeing that, after
12 the initial 90 day period, Burlingame and SCG would each be
13 entitled to submit independent bids, Burlingame waived any right
14 to claim that SCG's purchase the Original Comerica Loans would
15 violate Burlingame's contractual rights. Burlingame contended
16 that paragraph 2 of the June 14 Agreement, which permitted SCG to
17 bid, was essentially nullified by paragraph 5, which provided that
18 Burlingame's contractual rights remained unaffected. At best this
19 provision was ambiguous.

20 Jan Judson testified that this issue was negotiated at the
21 time the June 14 Agreement was executed. She claimed that the
22 parties understood that Burlingame was preserving its right to
23 contend that SCG was not entitled to bid. The Court did not
24 believe her testimony. Such an important provision would have
25 been spelled out more clearly in the written agreement. Moreover,
26

1 the Court did not believe that Zakariya would have agreed to such
2 a provision.

3 **(2) Alleged Acts of Bad Faith**

4 As noted above, Burlingame alleged ten acts of bad faith by
5 the Koellings as follows: (1) failing to inform Burlingame that
6 SCG had previously made an offer to purchase the Original Comerica
7 Loans in May 2004 for \$2.1 million, (2) failing to provide
8 Burlingame with information and documents to assist it in
9 formulating an offer to purchase the Original Comerica Loans, (3)
10 supplying Burlingame with fraudulent and misleading documents, (4)
11 refusing to provide Burlingame with information concerning prior
12 efforts to purchase the Original Comerica Loans, (5) assisting SCG
13 in its efforts to purchase the Original Comerica Loans, (6)
14 agreeing to release Comerica from any claim by Qmect and the
15 Koellings if the Original Comerica Loans were sold to Qmect
16 Funding, (7) representing to creditors and others in the lending
17 community that Qmect was arranging for new financing, (8)
18 misrepresenting Qmect's finances, (9) misrepresenting Qmect's
19 relationship with SCG, and (10) misrepresenting Qmect's
20 relationship with Qmect Funding. The Court's findings and
21 conclusions with respect to these allegations are set forth below.

22 **Items (1) and (4).**

23 Items (1) and (4) overlap or are duplicative. Item (1)
24 asserts that the Koellings acted in bad faith within the meaning
25 of the June 14 Agreement by failing to inform Burlingame that SCG
26 had previously made an offer to purchase the Original Comerica

1 Loans in May 2004 for \$2.1 million. Item (4) asserts that the
2 Koellings acted in bad faith by refusing to provide Burlingame
3 with information concerning prior efforts to purchase the Original
4 Comerica Loans. Having considered the evidence and the argument
5 of the parties, the Court finds and concludes that these acts or
6 omissions do not serve as a basis for finding that the Koellings
7 acted in bad faith within the meaning of the June 14 Agreement.

8 It is undisputed that, in May 2004, SCG offered to purchase
9 the Original Comerica Loans for \$2.1 million. The Judsons
10 testified that, although they learned that an offer had been made
11 in early June 2004, they did not learn the amount of the offer.
12 Later, when the parties entered into the June 14 Agreement, and
13 during the initial period during which Burlingame had the
14 exclusive right to attempt to purchase the Original Comerica
15 Loans, the Koellings did not tell Burlingame the amount that SCG
16 had offered in May 2003. Burlingame contended that, if it had
17 known that SCG had offered to purchase the Original Comerica Loans
18 for \$2.1 million in May 2003, it would not have offered to
19 purchase them for \$1.6 million in June 2003.

20 Fred Koelling and Zakariya admitted that they did not disclose
21 to Burlingame the amount of the offer made by SCG in May 2003.
22 However, it was undisputed that the Judsons never asked either
23 individual what amount had been offered. Both individuals stated
24 that, if the Judsons had asked, they would have told them the
25 amount of the offer. The Court believed them.
26

1 Moreover, the Court is persuaded that, even if the Judsons had
2 known the amount of SCG's May 2003 offer, Burlingame would not
3 have offered any more for the Original Comerica Loans during the
4 initial 90 day period. It is undisputed that, in the fall of
5 2002, Burlingame entered into negotiations with Comerica
6 concerning the purchase of the Original Comerica Loans and was
7 advised at that time that Comerica was unwilling to sell the loans
8 for less than a \$100,000 discount off the \$2.7 million face amount
9 of the loans. Given that prior history, Burlingame's offers
10 during the initial initial 90 day period were clearly unreasonably
11 low. Moreover, Fred Koelling testified that he told Bob Judson
12 that \$1.6 million was too low and that he should offer something
13 in the range of \$1.8 to \$2 million. The Court believed him.

14 **Items (5), (6), (9), and (10)**

15 These items also overlap or are duplicative. Item (5)
16 asserts that that the Koellings acted in bad faith by assisting
17 SCG in its efforts to purchase the Original Comerica Loans. Item
18 (6) asserts the Koellings acted in bad faith by agreeing to
19 release their and Qmect's claims against Comerica if Qmect Funding
20 bought the Origianl Comerica Loans. Item (9) asserts that the
21 Koellings acted in bad faith by misrepresenting their relationship
22 with SCG. Item (10) asserts that the Koellings acted in bad faith
23 by misrepresenting Qmect's relationship with Qmect Funding.
24 Having considered the evidence and the argument of the parties,
25 the Court finds and concludes that these acts or omissions do not
26

1 serve as a basis for finding that the Koellings acted in bad faith
2 within the meaning of the June 14 Agreement.

3 It is undisputed that the Koellings assisted Zakariya in his
4 attempts to purchase the Original Comerica Loans after Burlingame
5 failed to do so during the initial 90 day period period. Among
6 other things, they agreed to release any claims against Comerica
7 and to indemnify it against claims and/or defense costs resulting
8 from litigation by Burlingame, both on their own behalf and on
9 behalf of Qmect. However, there is nothing in the June 14
10 Agreement that requires them to refrain from assisting one party
11 in acquiring the Original Comerica Loans after the initial 90 day
12 period had passed.

13 The Judsons testified that, during this period, Fred Koelling
14 misrepresented to them that he was no longer working with
15 Zakariya. The Court was not persuaded on this point. However,
16 even if he had, the Court would not find that this constituted a
17 violation of the Good Faith Provision. After the initial 90 day
18 period, if Burlingame had wanted to bid on the Original Comerica
19 Loans in good faith, it would have done so regardless of whether
20 Fred Koelling was still attempting to arrange a sale to Qmect
21 Funding. The Court surmises that, in fact, Burlingame did not
22 wish to purchase the Original Comerica Loans. It simply did not
23 want to have Qmect Funding or anyone else friendly to Qmect
24 purchase them. However, the Good Faith Provision did not entitle
25 Burlingame to compel the Koellings to cooperate with that
26 strategy.

1 **Items (2), (3), and (8)**

2 Items (2), (3), and (8) are also either duplicative or
3 overlapping. Item (2) asserts that the Koellings failed to
4 provide information and documents to assist Burlingame in making
5 an offer to purchase the Original Comerica Loans. Item (3)
6 asserts that the Koellings supplied Burlingame with fraudulent and
7 misleading documents. Item (8) asserts that the Koellings
8 misrepresented Qmect's finances. Burlingame failed to present
9 persuasive evidence supporting these allegations.

10 It was undisputed that the Koellings provided Burlingame with
11 substantial information to assist it in making the second offer
12 for \$1.4 million. The initial offer for \$1.6 million was made
13 almost immediately after the June 14 Agreement was executed.
14 Thus, there would have been no time to provide Burlingame with
15 additional financial information.

16 Substantial evidence was presented that Fred Koelling failed
17 to provide financial information requested by Burlingame on or
18 about October 29, 2003 until January 14, 2004. SCG made an offer
19 to purchase the Original Comerica Loans on October 29, 2003.
20 Thus, there is some evidence that Fred Koelling delayed providing
21 Burlingame with financial information so that SCG could have an
22 advantage in bidding on the Original Comerica Loans.

23 However, the Court was not persuaded that this was what
24 caused Fred Koelling to delay providing the requested information
25 for so long. The request for information was extremely detailed.
26 Qmect was short-staffed. Fred Koelling testified at trial that he

1 did not believe at that point that Burlingame had any intention of
2 purchasing the Original Comerica Loans. The Court believed him.

3 Moreover, as discussed above, the Court was persuaded that
4 Burlingame did not sincerely wish to purchase the Original
5 Comerica Loans. It simply wished to block anyone else from doing
6 so. The Court was persuaded that Burlingame purchased the
7 Original Comerica Loans as a last resort. Thus, the Court finds
8 and concludes that Fred Koelling's delay in providing the
9 requested financial information to Burlingame did not violate the
10 Good Faith Provision of the June 14 Agreement.

11 **Item (7)**

12 Item (7) asserts that Fred Koelling represented to creditors
13 and others in the lending community that Qmect was arranging for
14 new financing. The Koellings did not dispute this asserted fact.
15 However, no persuasive argument was made that this act constituted
16 a violation of the Good Faith Provision of the June 14 Agreement.

17 **(3) Appointment of Robert Sick as CEO**

18 Burlingame also asserted that the Koellings were not entitled
19 to a release of liability pursuant to the Comerica Guaranties
20 because Fred Koelling refused to let Burlingame appoint a new CEO
21 for Qmect after Burlingame acquired the Original Comerica Loans.
22 As set forth above, the June 14 Agreement provided that, if
23 Burlingame purchased the Original Comerica Loans, it had the right
24 to do so. It was required to consult with Fred Koelling but had
25 the ultimate say in whom to appoint. The new CEO would be
26

1 entitled to run Qmect until such time as Burlingame's claims were
2 paid in full.

3 It is undisputed that, after Burlingame acquired the Original
4 Comerica Loans and after its attempt to foreclose on Qmect's
5 assets were blocked by Qmect's chapter 11 filing, Burlingame
6 attempted to appoint Robert Sick as Qmect's CEO. The Court finds
7 and concludes that Burlingame did not consult with Fred Koelling
8 before selecting Robert Sick. However, more important, Burlingame
9 also did not request relief from the automatic stay to exercise
10 this right. Clearly, under the terms of the June 14 Agreement,
11 the right to appoint a new CEO constituted an attempt to exercise
12 control over the assets of the debtor. 11 U.S.C. § 362(a)(3).
13 Thus, the attempt to appoint Robert Sick as the CEO without first
14 requesting relief violated the automatic Stay.

15 Moreover, the Court would not have granted relief to permit
16 Burlingame to exercise this remedy unless it was prepared to grant
17 relief from stay in toto. In a chapter 11 case, the debtor-in-
18 possession is a fiduciary for all creditors. If the debtor-in-
19 possession is not performing this function, the appropriate remedy
20 is to move for appointment of a chapter 11 trustee. Burlingame
21 would have the right to suggest that Robert Sick be appointed in
22 this capacity. However, the Court has the right to decide whether
23 a chapter 11 trustee should be appointed, and the Office of the
24 United State Trustee has the right to select the individual to
25 perform that role.
26

1 In sum, the Court finds that the Koellings have not acted in
2 bad faith within the meaning of the Good Faith Provision and that
3 their refusal to let Robert Sick take over Qmect and the new CEO
4 after the chapter 11 was filed does not deprive them of the right
5 to a release from the Comerica Guaranties.

6 **2. Koelling Cross-Complaint**

7 As tried to the Court, the Koelling Cross-Complaint included
8 three claims for relief, for (1) breach of contract, (2)
9 intentional interference with prospective economic advantage, and
10 (3) declaratory relief. The Koellings have the burden of proof on
11 all three claims. The Court's findings of fact and conclusions of
12 law with respect to these claims are set forth in Section B-2-a,
13 B-2-b, and B-2-c, respectively.

14 **a. Breach of Contract**

15 In this claim for relief, the Koellings alleged that, after
16 Burlingame's exclusive bidding period expired, they worked with
17 SCG over a period of months to assist SCG in purchasing the
18 Original Comerica Loans, incurring substantial costs in the
19 process. About the time that the Qmect Funding Sale Agreement was
20 ready to be signed, Burlingame learned about it. Burlingame's
21 counsel threatened Comerica with litigation if Comerica proceeded
22 with the sale, thereby causing Comerica to withdraw from the
23 agreement. The claim for relief alleged that the Koellings were
24 damaged as a result of the breach.

25 As set forth above, in connection with Qmect's similar claim
26 for breach of contract, the Court finds and concludes that the

1 Koellings performed their obligations under the June 14 Agreement,
2 that Burlingame breached its obligations by sending the Second and
3 Third Litigation Threat Letters, and that by its breach,
4 Burlingame caused Comerica to renege on its agreement to sell the
5 Original Comerica Loans to Qmect Funding. However, for the same
6 reasons stated in connection with that claim, the Court finds and
7 concludes that judgment must be granted in favor of Burlingame on
8 this claim.

9 The Koellings failed to present persuasive evidence that they
10 were damaged by Burlingame's breach: i.e., that they would have
11 been better off if Qmect Funding had acquired the Original
12 Comerica Loans. Notably, they had no agreement with Zakariya that
13 Qmect Funding would release them from the Comerica Guaranties if
14 it acquired the Original Comerica Loans. Although they did
15 present evidence that they spent a substantial amount of money
16 assisting Qmect Funding in its attempt to acquire the Original
17 Comerica Loans, they would have been required to spend this money
18 in any event if the Qmect Funding Sale Agreement had gone through.
19 No evidence was presented that they would have been reimbursed for
20 these expenditures.

21 **b. Intentional Interference With Prospective Economic**
22 **Advantage**

23 In this claim for relief, the Koellings alleged that, in
24 February 2004, Burlingame knew that SCG was about to acquire the
25 Original Comerica Loans. It knew that this would have
26 significantly eased Qmect's debt burden and that the Koellings

1 would have been released from the Comerica Guaranties. The
2 Koellings alleged that Burlingame intentionally interfered with
3 the SCG acquisition by causing Comerica to renege on its agreement
4 to sell the Original Comerica Loans to SCG.

5 As a result, the Koellings alleged, they have a significantly
6 higher debt on the Original Comerica Loan--i.e., pursuant to the
7 Comerica Guaranties--that they would have had if SCG had acquired
8 them. They have also been required to defend Burlingame's
9 frivolous claim that the Comerica Guaranties have not been
10 released. For the reasons discussed above, this claim must also
11 fail.

12 The elements of a claim for intentional interference with
13 prospective economic relations have been recited above in
14 connection with Qmect's similar claim and will not be repeated
15 here. It was undisputed that, at the time the Second and Third
16 Litigation Threat Letters were sent, Burlingame knew about Qmect's
17 and the Koellings' relationship with SCG and Qmect Funding.
18 However, the evidence presented did not support the allegation
19 that Burlingame knew that Qmect and the Koellings would be better
20 off financially if Qmect Funding purchased the Original Comerica
21 Loans. The evidence merely supported the finding that the Judsons
22 felt that Burlingame would be worse off financially if this
23 occurred. More important, the Court was not persuaded that, more
24 probably than not, Qmect and the Koellings would have been better
25 off if Qmect Funding had purchased the Original Comerica Loans.
26

1 The Koellings simply failed to meet their burden of proof on this
2 issue.

3 The Koellings also claim as an element of damages that, if
4 Qmect Funding had acquired the Original Comerica Loans, they would
5 not have had to defend against a frivolous claim that they were
6 not entitled to a release from the Comerica Guaranties. This
7 claim has several problems. First, although the Court has found
8 in favor of the Koellings on this claim, it does not find the
9 contention frivolous. Second, and more important, the reason they
10 would not have had to defend against a claim of this sort is that,
11 if Qmect Funding purchased the Original Comerica Loans, the
12 Koellings had no contractual right to a release from the Comerica
13 Guaranties. This can hardly be seen as an improvement in the
14 Koellings' position.

15 **c. Declaratory Relief**

16 In this claim for relief, the Koellings alleged that a
17 controversy has arisen concerning the rights and duties of the
18 parties under the terms of the June 14 Agreement, including (1)
19 whether the June 14 Agreement constitutes a valid and binding
20 obligation, (2) whether the Koellings performed under the June 14
21 Agreement, (3) whether Burlingame breached its obligations under
22 the June 14 Agreement, (4) whether the Koellings acted in good
23 faith throughout the bidding process, and (5) whether the
24 Koellings are released from the Comerica Guaranties.

1 This claim for relief overlaps with or duplicates other
2 claims asserted in these consolidated proceedings. However, the
3 Court will repeat its findings and conclusions here:

4 (1) No factual or legal basis was presented at trial
5 challenging the validity or enforceability of the June 14
6 Agreement. Therefore, the Court finds and concludes that it is a
7 valid and enforceable agreement.

8 (2) The Court finds and concludes that the Koellings
9 performed their obligations under the June 14 Agreement.

10 (3) The Court finds and concludes that Burlingame breached
11 its obligation under the June 14 Agreement to act in good faith to
12 achieve the purposes of the agreement.

13 (4) The Court finds and concludes that the Koellings acted
14 in good faith to achieve the purposes of the June 14 Agreement.

15 (5) The Court finds and concludes that the Koellings are
16 entitled to a release from their obligations under the Comerica
17 Guaranties.

18 **C. BREACH OF FIDUCIARY DUTY ACTION**

19 As tried to the Court, the Breach of Fiduciary Duty Complaint
20 no longer had any claims for relief. However, the Burlingame
21 Cross-Complaint contained six claims for relief: (1) breach of
22 unconditional guaranty, (2) tortious interference with contractual
23 relations, (3) breach of fiduciary duty, (4) contractual/implied
24 indemnity and contribution¹¹, (5) declaratory relief, and (6)
25

26 ¹¹The Burlingame Cross-Complaint contains a general
allegation that Qmect is the alter ego of the Koellings. Some

1 breach of subordination agreement. All six claims were asserted
2 against the Koellings. The fourth, fifth, and sixth claims were
3 also asserted against Qmect. Burlingame has the burden of proof
4 on all six claims. The Court's findings of fact and conclusions
5 of law with respect to all six claims are set forth in sections C-
6 1, C-2, C-3, C-4, C-5, and C-6 below.

7 **1. Breach of Unconditional Guaranty**

8 In this claim for relief, Burlingame alleged that the
9 Koellings executed the Burlingame Guaranty, guaranteeing the
10 performance of Qmect's obligations under the Burlingame Loan
11 Agreement. It alleged that the Koellings breached their
12 obligations under the Burlingame Guaranty by failing to pay the
13 obligations due under the Burlingame Guaranty upon demand.
14 Burlingame presented sufficient evidence to support these
15 allegations at trial, and the Koellings presented no contrary
16 evidence. The only issue presented by this claim is whether
17 Burlingame is entitled to satisfy its judgment on this claim from
18 the Koellings' interest in Kids Connection: i.e., whether the
19 Koellings' conduct has deprived them of the Carve Out and, if so,
20 to what extent.

21 As recited above, the Carve Out--paragraph 9 of the
22 Burlingame Guaranty--prevented Burlingame from seeking to satisfy
23 its claim under the Burlingame Guaranty against the Koellings'
24 interest in Kids Connection. However, the effectiveness of the
25

26 of the claims are asserted against the Koellings as well as
Qmect in reliance on that theory.

1 Carve Out depended upon the Koellings' not investing "additional
2 cash or other assets" in Kids Connection and not purchasing
3 additional shares of stock or any other form of ownership in Kids
4 Connection. At trial, Burlingame contended that the Koellings
5 lost their right to the Carve Out by virtue of the September 2002
6 Salary Increase and the June 2003 \$1.5 Million Note assignment.
7 The Koellings contended that neither of the actions were
8 sufficient to deprive them of the Carve Out. Alternatively, they
9 contended that, if the June 2003 \$1.5 Million Note assignment
10 violated the Carve Out provision, the only asset that was thereby
11 exposed to Burlingame's claim was the \$1.5 Million Note.¹² As
12 recited above, the undisputed evidence presented at trial
13 established that, in September 2002, Linda Koelling entered into
14 an agreement with Kids Connection, increasing her annual salary
15 from \$80,000 to \$225,000 and securing it with a deed of trust on
16 the Kids Connection Real Property. Burlingame contended that this
17 constituted the investment of additional cash of other assets in
18 Kids Connection, thereby depriving the Koellings of the right to
19 the Carve Out. This contention has no merit. To the contrary,
20 Linda Koelling's increased salary and the lien on the Kids
21 Connection Real Property securing her right to that salary
22

23 ¹²The Koellings also argue that, even if either of these
24 events constituted the transfer of an asset, the result of the
25 event would not be a total loss of the Carve Out. The asset
26 transferred would simply be made available to satisfy
Burlingame's judgment on the Burlingame Guaranty. This
argument is clearly at odds with the plain language of Carve
Out.

1 increased the Koellings' personal assets available to Burlingame
2 for execution of any money judgment. While this additional or
3 enhanced asset was related to Kids Connection, it did not
4 constitute an interest in Kids Connection. Therefore, it was not
5 an Excluded Asset, within the meaning of the Carve Out.

6 On the other hand, the Court finds and concludes that
7 assignment of the \$1.5 Million Promissory Note to Kids Connection
8 does deprive the Koellings of their right to the Carve Out. Prior
9 to its assignment, the \$1.5 Million Promissory Note was an asset
10 of the Koellings available for execution of a money judgment
11 obtained by Burlingame. After its assignment, if the Carve Out
12 were enforced, it would be not be available for that purpose.
13 Thus, in theory at least, the assignment of the \$1.5 Million Note
14 to Kids Connection decreased the assets available to Burlingame
15 for execution and increased the value of Linda Koellings' interest
16 in Kids Connection. This is precisely the situation addressed by
17 the Carve Out.

18 The Koellings contend that they should not lose the Carve Out
19 as a result of this transaction for two reasons. First, they
20 contend that they were only the nominal owners of the \$1.5 Million
21 Note. They presented persuasive evidence that the funds loaned to
22 Qmect, as evidenced by the \$1.5 Million Note, came from Kids
23 Connection, not them. They documented the transaction as a loan
24 from Kids Connection to themselves and a second loan from
25 themselves to Qmect on advice of their accountant, for tax
26 purposes.

1 The Court is not persuaded by this contention. When the
2 Koellings signed the Comerica Guaranty, they were entitled to
3 repayment of the \$1.5 Million Note, not Kids Connection.
4 Burlingame knew about the loan and that the Koellings were the
5 holders of the \$1.5 Million Note. The Carve Out was negotiated
6 based on the Koellings' assets at that time. If the parties had
7 intended that the assignment of \$1.5 Million Loan to Kids
8 Connection would not deprive the Koellings of the Carve Out, that
9 exclusion would surely have been spelled out in the Comerica
10 Guaranty.

11 Second, the Koellings contend that the assignment of the \$1.5
12 Million Note should not deprive them of the Carve Out because the
13 \$1.5 Million Note had no value. Persuasive evidence was presented
14 that, at the time the \$1.5 Million Note was assigned to Kids
15 Connection, Qmect was insolvent, on both a going concern and
16 liquidation basis. Thus, more likely than not, the \$1.5
17 Million Note had no monetary value.

18 The question remains whether the term "asset" as used in the
19 Carve Out should be read to mean "asset with a monetary value."
20 The term "asset" is not defined in the Burlingame Guaranty.
21 However, Black's Law Dictionary defines "assets" as "[p]roperty of
22 all kinds...." It does not limit the definition to property with
23 a monetary value. Moreover, even though Qmect could not have
24 repaid the \$1.5 Million Note, it does not follow that the \$1.5
25 Million Note had no value to Burlingame.
26

1 Prior to June 9, 2003, pursuant to the Burlingame Guaranty,
2 Burlingame had the right to foreclose on Fred Koellings' stock
3 which, at that time represented a majority interest in Qmect. If
4 Burlingame had exercised that right, it would become the majority
5 owner of Qmect. If the Koellings had retained the \$1.5 Million
6 Note, Burlingame could have increased the value of its equity
7 interest by foreclosing on the \$1.5 Million Note and then
8 releasing it.

9 Moreover, the value of Qmect's assets more likely than not
10 exceeded the balance of the Original Comerica Loans. It seems
11 inappropriate to include Burlingame's own secured loans in the
12 calculation by which one determines that the \$1.5 Million Note had
13 no value. In sum, the Court concludes that the assignment of the
14 \$1.5 Million Note did constitute the investment of an additional
15 asset in Kids Connection, thereby depriving the Koellings of the
16 Carve Out.

17 **2. Tortious Interference With Contractual Relations**

18 In this claim for relief, Burlingame alleged that, in 2001,
19 Qmect and Burlingame entered into the Burlingame Loan Agreement.¹³
20 In paragraph 7 of the Burlingame Loan Agreement, Qmect agreed not
21

22
23 ¹³This claim for relief mistakenly includes Kids Connection
24 as a cross-defendant. The claims against Kids Connection have
25 been remanded to state court. In addition, Fred Koelling was
26 added as a cross-defendant to this claim. Finally, the Court
believes that Burlingame intended to allege that both the
Koellings knew of the agreements, not just that Linda Koelling
knew of them.

1 to do certain things without Burlingame's consent.¹⁴ Burlingame
2 alleged that the Koellings tortiously interfered with these
3 contractual obligations by causing Qmect to breach them: i.e., by
4 issuing additional stock and transferring it to Kids Connection,
5 BDS, McNeil, and Qmect Funding. With respect to this claim,
6 Burlingame sought both compensatory and punitive damages.¹⁵

7 As noted by Burlingame, to establish this claim, it was
8 required to prove: (1) the existence of a contract between Qmect
9 and Burlingame, (2) the Koellings' knowledge of that contract, (3)
10 the Koellings' intent to disrupt Qmect's performance of that
11 contract, (4) the actual disruption of performance, and (5)
12 causation: i.e., that the Koellings' conduct was a substantial
13

14 ¹⁴Burlingame also alleged in this claim that the Koellings
15 tortiously interfered with Burlingame's contractual relations
16 with Qmect by reassigning the \$1.5 Million Note to Kids
17 Connection, by issuing additional stock and transferring it to
18 Kids Connection in satisfaction of \$250,000 of the \$1.5 Million
19 Note obligation, and by failing to deliver the Kids Connection
20 Stock to Burlingame as required by the Subordination Agreement.
21 To the extent these allegations are based on a breach of the
22 Subordination Agreement, they are not appropriately included in
23 this claim for relief. The Subordination Agreement imposed
24 obligations on Koellings, not Qmect. A claim for tortious
25 interference cannot be based on a breach of one's own contract.
26 These allegations are set forth more appropriately in the last
claim for relief, for breach of the Subordination Agreement. See
below.

¹⁵Burlingame sought a determination that Kids Connection was
the Koellings' alter ego such that the assets of Kids Connection
would be available to satisfy this claim. The Court was not
persuaded by the evidence presented at trial that Kids
Connection's separate corporate status should be disregarded in
this fashion.

1 factor in causing the disruption. An officer or shareholder is
2 not automatically immune from such a claim. However, an officer
3 or shareholder may establish a privilege defense by proving that
4 he or she acted for the benefit of the corporation. See Woods v.
5 Fox Broadcasting Sub., Inc., 129 Cal. App. 4th 344, 350-56 (2005).

6 The undisputed evidence clearly established three of the five
7 elements of the claim. Burlingame and Qmect were parties to the
8 Burlingame Loan Agreement. The Koellings knew of the Burlingame
9 Loan Agreement. Moreover, by causing Qmect to issue and transfer
10 additional stock so that the Burlingame Stock Collateral no longer
11 represented a majority interest in Qmect, Fred Koelling
12 effectively induced Burlingame to cancel its foreclosure sale of
13 the Burlingame Stock Collateral.

14 Fred Koelling disputed the contention that he caused Qmect to
15 issue and transfer the additional stock in order to disrupt
16 Qmect's performance. He testified that his motives in causing
17 Qmect to issue and transfer the stock were unrelated to
18 Burlingame's efforts to foreclose. The Court did not believe him.
19 Thus, the third element of the claim is also established. The
20 remaining issues are (1) whether the issuance and transfer of the
21 additional stock violated the Burlingame Loan Agreement and (2) if
22 so, whether Fred Koelling has established a privilege defense.¹⁶

23
24
25
26 ¹⁶The evidence presented failed to establish that Linda
Koelling had any active participation in this transaction.
Therefore, this claim will not lie against her.

1 Burlingame alleged that Qmect's issuance of additional shares
2 in June 2003 violated the seven negative covenants contained in
3 paragraph 7 of the Burlingame Loan Agreement: (1) paragraph 7.1,
4 disposing of any assets outside the ordinary course of business,
5 (2) paragraph 7.2, permitting a Change in Control, (3) paragraph
6 7.5, incurring or permitting to be incurred a lien on its assets,
7 (4) paragraph 7.6, paying any dividends, (5) paragraph 7.8,
8 entering into any material transaction with an affiliate outside
9 the ordinary course of business, (6) paragraph 7.9, making any
10 payment on any subordinated debt, and (7) paragraph 7.12, entering
11 into a contract with a provision restricting the creation of a
12 security interest in Qmect's property.

13 The claim that Burlingame violated the negative covenants in
14 paragraphs 7.5, 7.6, 7.9, and 7.12 lacks any merit and may be
15 disposed of summarily. No evidence was presented that Burlingame
16 incurred or permitted to be incurred any lien on its property
17 (paragraph 7.5), paid any dividends to shareholders (paragraph
18 7.6), made any payment on subordinated debt-i.e., to the Koellings
19 (paragraph 7.9), or entered into a contract with a provision
20 restricting the creation of a security interest in Qmect's
21 property (paragraph 7.12). The claim that Burlingame breached
22 three of the negative covenants contained in paragraph 7-
23 -paragraphs 7.1, 7.2, and 7.8--requires some discussion.

24 **Paragraph 7.1**

25 In paragraph 7.1 of the Burlingame Loan Agreement, Qmect
26 agreed not to transfer any of its property to a third party

1 outside the ordinary course of business without Burlingame's
2 consent. It is undisputed that the issuance and transfer of the
3 additional stock in June 2003 was outside the ordinary course of
4 business and that Burlingame did not consent to the transaction.
5 The only issue is whether the issuance and transfer of previously
6 unissued stock in a corporation constitutes the transfer of
7 property of the corporation. The Court concludes that it does
8 not.

9 In Decker v. Advantage Fund Ltd., 362 F.3d 593 (9th Cir.
10 2004), a chapter 7 trustee sued to avoid as fraudulent the
11 transfer by an insolvent corporate debtor of previously unissued
12 stock. At issue in the case was whether the stock constituted
13 property of the debtor corporation. The Decker court held that it
14 was not, that it was merely equity in the corporate debtor. The
15 Decker court cited with approval In re Curry & Sorenson, Inc., 57
16 B.R. 824, 829 (Bankr. 9th Cir. 1986), which reached the same
17 conclusion. Decker, 362 F.3d at 596. Based on this authority,
18 the Court concludes that Fred Koelling did not violate the
19 negative covenant in paragraph 7.1 of the Burlingame Loan
20 Agreement by causing Qmect to issue and transfer the additional
21 stock in June 2003.

22 **Paragraph 7.2**

23 In paragraph 7.2, Qmect agreed not to suffer or permit a
24 Change in Control without Burlingame's consent. It is undisputed
25 that Burlingame never consented to a Change in Control.
26 Burlingame contends that the issuance and transfer of the

1 additional stock to Kids Connection constituted a Change in
2 Control. Change in Control is a defined term. However,
3 essentially, it means that someone other than Fred Koelling would
4 hold a majority of the stock "ordinarily entitled to vote."

5 Burlingame concedes that the issuance and transfer of the
6 additional stock to Kids Connection Funding did not give Kids
7 Connection a majority of the stock. However, it contended that
8 the issuance and transfer gave Kids Connection Funding a majority
9 of stock entitled to vote. It reached this conclusion based on
10 the provision in Subordination Agreement giving Burlingame, rather
11 than Fred Koelling, the right to vote Fred Koelling's stock if
12 Qmect were in default. This method of counting cannot be squared
13 with the phrase recited above: i.e., "ordinarily entitled to
14 vote" Thus, the Court concludes that Qmect did not violate the
15 negative covenant set forth in paragraph 7.2 by issuing and
16 transferring the additional stock to Kids Connection in June 2003.

17 **Paragraph 7.8**

18 In paragraph 7.8, Qmect agreed not to enter into any material
19 transaction with an affiliate outside the ordinary course of
20 business. Burlingame contends that by Qmect violated this
21 provision by issuing and transferring additional stock to Kids
22 Connection in exchange for which Kids Connection forgave \$250,000
23 of the obligation represented by the \$1.5 Million Note. The Court
24 agrees.

25 Kids Connection was owned by Linda Koelling who was also a
26 shareholder of Qmect. Thus, Kids Connection was an affiliate of

1 Qmect. The issuance and transfer of the additional stock in June
2 2003 was clearly outside the ordinary course of business. Since
3 it altered Fred Koelling's percentage of the stock from a majority
4 to 12 percent, it was clearly a material transaction. Fred
5 Koelling clearly participated in this transaction and is liable on
6 the claim. The case against Linda Koelling is not as strong.
7 However, as a director, the transaction could not have occurred
8 without her consent. Therefore, the Court finds her liable on the
9 claim as well.

10 However, Burlingame failed to establish any compensatory
11 damages at trial for which the Koellings are not already liable
12 pursuant to the Burlingame Guaranty. Burlingame also sought
13 punitive damages. The Court finds and concludes that the
14 Koellings' conduct under these circumstances does not warrant the
15 imposition of punitive damages. Thus, Burlingame is entitled to
16 judgment on this claim in the amount of the additional interest
17 that accrued and costs of collection incurred on the Burlingame
18 Proof of Claim from June 9, 2003 to the date the Koellings filed
19 their bankruptcy petition.

20 **3. Breach of Fiduciary Duty**

21 In this claim for relief, Burlingame alleged that the
22 Koellings are directors of Qmect. It alleged that, on June 11,
23 2003, the Koellings moved for a temporary restraining order so as
24 to restrain Burlingame's public sale of Qmect's stock and that
25 their motion was denied. It alleged that, on June 12, 2003, with
26 the intent to hinder, delay, and defraud Burlingame's rights under

1 the Burlingame Loan agreements, the Koellings improperly caused
2 Qmect to issue additional stock to Kids Connection, BDS, McNeil,
3 and Qmect Funding. It alleged that the improper issuance of this
4 stock diluted Fred Koelling's interest in Qmect from a controlling
5 interest to 12 percent, which substantially decreased its value as
6 Burlingame's collateral.

7 Burlingame alleged that, at the time the additional stock was
8 issued, Qmect was "facing insolvency." As a result, Burlingame
9 contended, the Koellings, as directors, owed a fiduciary duty to
10 Qmect's creditors, including Burlingame. Burlingame alleged that
11 Qmect breached that duty by issuing the additional stock in that
12 the stock was issued and transferred with the intent to defraud
13 Burlingame and was issued and transferred for less than reasonably
14 equivalent value.

15 It is undisputed that the Koellings are directors of Qmect
16 and that, in June 2003, Qmect issued additional shares of stock
17 and transferred them to third parties. It is also undisputed that
18 the result of this transaction was to dilute the Burlingame Stock
19 Collateral to less than a controlling interest in Qmect. The
20 Court finds and concludes that, more likely than not, Qmect was
21 insolvent when this transaction occurred. As discussed above,
22 notwithstanding Fred Koelling's testimony to the contrary, the
23 Court was persuaded that the purpose of the issuance and transfer
24 of this stock was to block the foreclosure sale. Thus, the
25 transaction was intended to hinder and delay Burlingame: i.e., a
26 creditor.

1 However, the claim asserted is not a fraudulent transfer
2 claim against the third parties who received the stock, seeking to
3 avoid the transfer. The claim is asserted against the Koellings
4 for breach of fiduciary duty. As discussed above, the Court has
5 already concluded that the issuance and transfer of the stock
6 breached the Burlingame Loan Agreement and that the Koellings are
7 liable for tortious interference with contractual relations for
8 their role in this transaction. The question is whether they are
9 also liable as a result of this transaction for breach of
10 fiduciary duty. For this question to be answered in the
11 affirmative, Burlingame must establish that the Koellings, as
12 directors, owe Burlingame a fiduciary duty and that the issuance
13 and transfer of the stock breached that duty.

14 Normally, the directors of a corporation have a fiduciary
15 duty only to the corporation and its shareholders. A shareholder
16 may assert two types of actions against a director: i.e., a
17 "direct action," alleging an injury to that shareholder's
18 particular interest, or a "derivative action," alleging an injury
19 to the corporation for which the corporation has failed or refused
20 to sue. Schuster v. Gardner, 127 Cal. App. 4th 305, 311-12
21 (2005).

22 When a corporation is insolvent, the fiduciary duty of the
23 directors extends to the creditors as well as to the shareholders.
24 Pepper v. Litton, 308 U.S. 295, 306 (1939). However, the duty
25 only runs to the creditor body as a whole, not to any particular
26 creditor. The trustee has the sole standing to assert a claim for

1 breach of this fiduciary duty. Id. Conceivably, in a bankruptcy
2 case, a creditor or creditors' committee could be authorized by
3 the court to assert a derivative claim for breach of fiduciary
4 duty on behalf of the estate. However, Burlingame has not sought
5 authorization to assert such a claim.

6 Burlingame cites a series of cases, which it contends
7 support its right to assert a breach of fiduciary duty claim on
8 its own behalf. None of these cases supports Burlingame's claim
9 of standing to do so. Therefore, the Koellings are entitled to
10 judgment on this claim for relief.

11 **4. Contractual/Implied Indemnity and Contribution**

12 In this claim for relief, Burlingame alleged that it was
13 entitled to be indemnified by Qmect and the Koellings pursuant to
14 four separate agreements: (1) the November 18, 1999 letter
15 agreement between Qmect and Sierra (the "Original Sierra
16 Agreement"),¹⁷ (2) the June 2001 Letter Agreement between
17 Burlingame, on the one hand, and Fred Koelling and Qmect, on the
18 other (the "2001 Letter Agreement"), (3) the Burlingame Loan
19 Agreement, and (4) the Burlingame Guaranty. Burlingame alleged
20 that each of these agreements provided that Qmect and/or the
21 Koellings are required to indemnify Burlingame for any claims or
22 expenses incurred as a result of its agreements with Qmect.

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26 ¹⁷The Original Sierra Agreement was amended in March 2000
but the amendment did not alter the agreement in any way
relevant to this claim.

1 Burlingame's claims clearly have no merit with respect to two
2 of these agreements. The Original Sierra Agreement contains an
3 indemnification provision. However, neither Burlingame nor
4 Burlingame Funding is a party to that agreement. Burlingame is a
5 party to the Burlingame Guaranty. However, the Burlingame
6 Guaranty does not contain an indemnification provision.

7 Burlingame is a party to the 2001 Letter Agreement, and it
8 does contain an indemnification provision. In this agreement,
9 Burlingame expressed an interest in loaning \$2,000,000 to Qmect on
10 specified terms although it made no commitment to make any loan.
11 The final paragraph of the 2001 Letter Agreement stated that,
12 regardless of whether Burlingame actually loaned Qmect any money,
13 Qmect agreed to indemnify Burlingame and hold it harmless from any
14 claims and expenses arising out of the 2001 Letter Agreement, any
15 financing, or any related investigation or proceeding.

16 Burlingame is also a party to the Burlingame Loan Agreement,
17 and the Burlingame Loan Agreement also contains an indemnification
18 provision. In paragraph 12.2 of the Burlingame Loan Agreement,
19 Qmect agreed to "defend, indemnify and hold [Burlingame] harmless"
20 from "(a) all...claims...asserted by any other party in connection
21 with the transactions contemplated by this Agreement...and (b) all
22 losses or...[Burlingame] Expenses...incurred...[or] paid
23 by...[Burlingame] as a result of...[the] transactions
24 between...[Burlingame and Qmect] whether under this Agreement, or
25 otherwise...except for losses caused by...[Burlingame's] gross
26 negligence or willful misconduct." Although the Koellings are not

1 parties to the Burlingame Loan Agreement, to the extent Qmect is
2 liable to Burlingame pursuant to paragraph 12.2, the Koellings are
3 also liable pursuant to the Burlingame Guaranty.

4 However, the Court concludes that this issue is moot. As
5 discussed above, Qmect and the Koellings asserted various claims
6 for relief against Burlingame. However, they failed to establish
7 any of their claims. Although the indemnification provisions may
8 still apply with respect to Burlingame's litigation expenses, to
9 the extent they were incurred pre-petition, both Qmect and the
10 Koellings are already liable for those expenses as costs of
11 collection under the Burlingame Loan Agreement.

12 **5. Declaratory Relief**

13 In this claim for relief, Burlingame alleged that a
14 controversy exists as to the parties' rights and obligations
15 under the various agreements. It sought a determination of those
16 rights and obligations. In particular, it sought a determination
17 that the issuance of additional stock on June 12, 2003 constituted
18 a fraudulent conveyance which should be set aside.

19 The Burlingame is not entitled to any judgment on this
20 claim. Except with respect to the issuance of the additional
21 stock, the claim was not alleged with sufficient specificity to
22 permit the Court to identify the nature of the disputed rights and
23 obligations with respect to which Burlingame seek declaratory
24 judgment. Moreover, the claim appears duplicative of other claims
25 asserted in these proceedings.
26

1 The claim for declaratory relief holding that the issuance of
2 the additional stock in June 2003 was a fraudulent transfer fails
3 for lack of standing. When the transferor is a bankruptcy debtor,
4 unless a creditor or creditors' committee is authorized to bring
5 a derivative action to avoid the transfer, only the trustee or
6 debtor-in-possession to assert such a claim. Even if the transfer
7 was made with the intention of hindering and delaying a specific
8 creditor, the transfer, if avoidable, will be avoided for the
9 benefit of all creditors. In re Curry & Sorensen, Inc., 57 B.R.
10 824, 827-28 (Bankr. 9th Cir. 1986); Matter of Pointer, 952 F.2d 82,
11 88 (5th Cir. 1992). A claim for declaratory relief may not be
12 prosecuted by a creditor without such authorization so as to
13 circumvent that limitation on standing.

14 **6. Breach of Subordination Agreement**

15 In this claim for relief, Burlingame alleged that the
16 Koellings and Burlingame entered into the Subordination Agreement.
17 It alleged that the Subordination Agreement provided in part as
18 follows:

19 Creditor [the Koellings] shall promptly
20 deliver to Lender [Burlingame] in the form
21 received (except for endorsement or assignment
22 by Creditor where required by Lender) for
23 application to the Senior Debt [the Original
Comerica Loans] any payment, distribution,
security or proceeds received by Creditor with
respect to the Subordinated Debt other than in
accordance with this Agreement.

24 Burlingame alleged that the Koellings breached the Subordination
25 Agreement by failing to promptly deliver to Burlingame the stock
26 or equivalent cash value received by Kids Connection from Qmect.

1 The Subordinated Debt is defined by the Subordination Agreement as
2 all of Qmect's debt to the Koellings, including all future debt.

3 The undisputed evidence presented at trial established that,
4 on June 9, 2006, the Koellings caused Qmect to issue additional
5 stock and to transfer some of that stock (the "Kids Connection
6 Stock") to Kids Connection in partial satisfaction of the \$1.5
7 Million Note. At the time the Subordination Agreement was
8 executed, as discussed above, the \$1.5 Million Note was owed by
9 Qmect to the Koellings. Burlingame contended that the Koellings
10 breached the Subordination Agreement by failing to promptly turn
11 over the Kids Connection Stock to Burlingame. The Court
12 disagrees.

13 As discussed above, the Koellings assigned the \$1.5 Million
14 Note to Kids Connection on June 9, 2003. Once they did this,
15 Qmect no longer owed this debt to the Koellings. Rather, Qmect
16 owed the debt to Kids Connection. Moreover, the Kids Connection
17 Stock was not issued to the Koellings; it was issued to Kids
18 Connection. Insufficient evidence was presented to establish that
19 Kids Connection should be treated as the Koellings' alter ego so
20 that its separate corporate status should be disregarded.
21 Therefore, the Koellings are entitled to judgment on this claim.

22 CONCLUSION

23 The Court's rulings on the claims presented at trial in these
24 consolidated adversary proceedings are summarized as follows:

25 A. EQUITABLE SUBORDINATION ACTION

26

1 **1. Intentional Interference With Prospective Economic**
2 **Advantage**

3 In this claim by Qmect against Burlingame, the Court grants
4 judgment in favor of Burlingame.

5 **2. Breach of Contract**

6 In this claim by Qmect against Burlingame, the Court grants
7 judgment in favor of Burlingame.

8 **3. Breach of Covenant of Good Faith and Fair Dealing**

9 In this claim by Qmect against Burlingame, the Court grants
10 judgment in favor of Burlingame.

11 **4. Objections to Proofs of Claim**

12 In this contested matter initiated by Qmect, the Court
13 overrules the objections to Burlingame's proofs of claim and
14 allows those claims as follows:

15 **a. Burlingame's Proof of Claim Against Qmect Estate**

16 The proof of claim filed by Burlingame in the Qmect
17 bankruptcy case is allowed in the following amounts: (1)
18 \$2,000,000 in principal, (2) \$1,043,635.01 in pre-petition
19 interest, (3) \$27,779.23 in late fees, and (4) \$357,998.59 in
20 costs of collection.

21 **b. Burlingame's Proof of Claim Against Koelling Estate**

22 The proof of claim filed by Burlingame in the Koelling
23 bankruptcy case is allowed in the following amounts: (1)
24 \$2,000,000 in principal, (2) \$1,455,180.55 in pre-petition
25 interest, (3) \$40,057.01 in late fees, and (4) \$1,413.132.80 in
26 costs of collection.

1 **c. Burlingame Funding's Proof of Claim Against Qmect Estate**

2 The proof of claim filed by Burlingame Funding in the Qmect
3 bankruptcy case is allowed in the following amounts: (1) \$187,500
4 in principal and \$1,696.31 in pre-petition interest pursuant to
5 the variable rate installment note, (2) \$537,816.96 in principal
6 and \$5,052.51 in pre-petition interest pursuant to the note
7 secured by a deed of trust, (3) \$894,737.22 in principal and
8 \$8,948.32 in pre-petition interest pursuant to the amended and
9 restated note secured by a deed of trust, and (4) \$900,000 in
10 principal and \$7,850.60 in prepetition interest pursuant to the
11 master revolving note.

12 **B. GUARANTY ACTION**

13 **1. Guaranty Complaint**

14 **a. Breach of Comerica Guaranties**

15 In this claim by Burlingame Funding against the Koellings,
16 the Court grants judgment in favor of the Koellings.

17 **b. Declaratory Relief**

18 In this claim by Burlingame Funding against the Koellings,
19 the Court declares that the Koellings are entitled to a release
20 from the Comerica Guaranties pursuant to the June 14 Agreement.

21 **2. Koelling Cross-Complaint**

22 **a. Breach of Contract**

23 In this claim by the Koellings against Burlingame, the Court
24 grants judgment in favor of Burlingame.

25 **b. Intentional Interference With Prospective Economic**
26 **Advantage**

1 In this claim by the Koellings against Burlingame, the Court
2 grants judgment in favor of Burlingame.

3 **c. Declaratory Relief**

4 In this claim by the Koellings against Burlingame, the Court
5 declares that: (1) the June 14 Agreement is a valid and binding
6 contract, (2) the Koellings performed their obligations under the
7 agreement, including their obligations under the Good Faith
8 Provision, (3) Burlingame breached the Good Faith Provision of the
9 agreement, and (4) the Koellings are entitled to a release from
10 the Comerica Guaranties.

11 **C. BREACH OF FIDUCIARY DUTY ACTION--BURLINGAME CROSS-COMPLAINT**

12 **1. Breach of Unconditional Guaranty**

13 In this claim by Burlingame against the Koellings, the Court
14 finds and concludes that, by assigning the \$1.5 Million Note to
15 Kids Connection, the Koellings lost their right to the Carve Out
16 set forth in paragraph 9 of the Burlingame Guaranty.

17 **2. Tortious Interference With Contractual Relations**

18 In this claim by Burlingame against the Koellings, the Court
19 grants judgment in favor of Burlingame. However, it awards only
20 compensatory damages in the amount of the additional interest
21 accrued and costs of collection incurred from June 9, 2003 to
22 November 16, 2004.

23 **3. Breach of Fiduciary Duty**

24 In this claim by Burlingame against the Koellings, the Court
25 grants judgment in favor of the Koellings.

26 **4. Contractual/Implied Indemnity and Contribution**

1 In this claim by Burlingame against Qmect and the Koellings,
2 the Court grants judgment in favor of Qmect and the Koellings on
3 grounds of mootness.

4 **5. Declaratory Relief**

5 In this claim by Burlingame against Qmect and the Koellings,
6 the Court grants judgment in favor of Qmect and the Koellings.

7 **6. Breach of Subordination Agreement**

8 In this claim by Burlingame against the Koellings, the Court
9 grants judgment in favor of the Koellings.

10 Counsel for Burlingame and Burlingame Funding is directed to
11 submit proposed forms of judgment in accordance with this
12 decision.

13 END OF DOCUMENT
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